Off the beaten track

by Justin Dini

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With a newfound aggressiveness, CalPERS is investing in hedge funds, buying stakes in private equity firms and loading up on junk bonds. How well will these moves work in a bear market?

Daniel Szente began his career teaching business to high school seniors in Hilliard, Ohio. After six years of explaining the basics of accounting and marketing to teenagers interested in figures more physical than fiscal, he was itching for something new and exciting.

"I got tired of teaching the same things," says Szente. "The problem for me, on the high school level, was that you could only go so deep."

Szente made his way into the world of money management. Two decades later, as chief investment officer of the $170 billion California Public Employees' Retirement System, he's still looking to take his work in exciting new directions. Named to his post last July, Szente has been spearheading an uncharacteristic aggressiveness by the nation's largest public pension plan. Long known as a shareholder activist with a plain-vanilla approach to portfolio management and a strong predilection for indexing, CalPERS is making a series of bold strategic bets that have catapulted it to the forefront of pension innovators.

In its most controversial move, the 69-year-old plan will dramatically increase its exposure to hedge funds, heaping $1 billion on top of the $425 million already invested in two hedge funds. The decision represented a striking vote of confidence in an asset class that has remained largely off-limits to public funds.

Two months ago CalPERS, which has in the past five years more than doubled its commitment to private equity, picked up ownership stakes in two private equity firms - a first for any public fund. CalPERS paid $175 million for a 5 percent interest in the Carlyle Group, the high-profile fund whose partners and consultants include former president George Bush and former Defense secretary Frank Carlucci, and it paid $60 million for a stake in a venture capital subsidiary of Texas Pacific Group. CalPERS now ranks as the nation's single largest private equity investor, having eclipsed the Washington and Oregon state plans, which had dominated the field.

And in its latest roll of the dice, the CalPERS board doubled its target allocation to high-yield bonds, from 5 percent to 10 percent of fixed-income assets.

"I'm trying to get a buzz going around here. I'm trying to get people to think more aggressively. Really, I want people to talk in the halls more," says the former educator.

The logic for CalPERS is transparent: to squeeze greater returns from its massive portfolio by increasing its exposure to asset classes outside public equities. The mandate, conceived during the '90s bull market, has taken on a new urgency in bearish times. Over the past five years, the CalPERS portfolio returned an average annual 12.7 percent, compared with 12.6 percent for the median public fund, according to Wilshire Associates' Trust Universe Comparison Service. Last year CalPERS fell by 1.4 percent, versus a 0.26 percent median decline for public funds with more than $1 billion in assets, putting it in the third quartile.

"We need equitylike exposure over the long haul," Szente says. "We don't necessarily need it all out of the public equity markets if we can find other good areas to get it from."

To be sure, CalPERS is hardly the first pension plan, public or private, to diversify into alternative assets to boost returns and, theoretically, mitigate risk. In 1989 the Virginia Retirement System committed between $10 million and $20 million to hedge funds; in 1996 the Ontario Teachers' Pension Plan Board followed suit with $50 million. And CalPERS's aggressiveness remains tempered. Although its investment in hedge funds is substantial for the $400 billion hedge fund industry, it still represents less than 1 percent of CalPERS's total assets. Still, the move by the industry leader inevitably carries special weight.

"Because of its size, sophistication and stature, CalPERS may be able to blaze a trail," says Scott Henderson, former executive director of the $32 billion Massachusetts Pension Reserves Investment Management Board. "Its decision could help make hedge funds more sensitive to the needs of public plans. I'm happy to be a free rider on this issue."

CalPERS intends to take it slow, doling out the $1 billion over a 12- to 18-month period. In January the plan sent "requests for information" query letters to 28 hedge fund consultants and funds-of-funds in its effort to hire a consultant to help guide the program. Szente and his staff have since narrowed the roster to about eight finalists. They aim to make their recommendation to the board this month.

The California plan may find that it's not so easy to spread the wealth around. At the moment, many hedge fund managers have more cash than they know what to do with.

"The critical question is 'Is there enough capacity in the hedge fund industry to take in all this money?' A billion is a lot to spend right now," says Bruce Ruehl, chief investment strategist at hedge fund consultant Tremont Advisers. By Ruehl's reckoning, 49 of the 50 top-performing hedge funds have closed their doors to new investors.

Moreover, hedge funds and public plans make unlikely partners. With their fiduciary obligation to protect the retirement savings of their plan participants, pension funds usually require extensive disclosure from their money managers. Hedge funds, of course, are notoriously secretive about their portfolios - their strategies, their leverage, their holdings. In addition, CalPERS is known in the money management community as an especially difficult client, demanding extensive briefings, hand-holding and frequent visits from its money managers.

"CalPERS is used to holding the stick," says a hedge fund consultant. "They're used to people begging them for their money and doing so on whatever terms CalPERS wants. It doesn't work that way in hedge funds. These guys are not willing to provide the transparency or the flexibility on pricing. They won't deal with the micromanaging and the four trips a year to Sacramento."

In which case they won't be seeing any of CalPERS's funds. "I'm not interested in giving anybody my money and praying," says Szente, who insists on transparency.

Not surprisingly, in boosting its commitment to alternative assets, CalPERS is cutting back on public equities. Under new asset allocation targets authorized last May, the plan's target for domestic equities fell from 41 percent to 39 percent, while international equities shrank from 20 percent to 19 percent; alternative investments increased from 4 percent to 6 percent; fixed income held steady at 24 percent; real estate increased from 6 percent to 8 percent; and cash, which had been 1 percent, disappeared entirely. CalPERS maintained its traditional reliance on passive management, indexing 80 percent of its domestic stock portfolio and 85 percent of its international stock portfolio, where emerging market investing has been overhauled (see box). That ratio of passive to active management has held fairly steady for the better part of 30 years.

"Every basis point counts," says Szente, who notes that more than 90 percent of the retirement plans that collectively make up CalPERS are overfunded. For the moment, at least, despite rolling blackouts and the occasional earthquake, the 1.2 million Californians relying on CalPERS can feel reasonably sanguine about their retirement.

A Californian Szente is not. Born in 1947, he grew up in Cleveland, Ohio, graduating from Ohio State University in 1972 with a bachelor of science degree in education. He found work teaching in the Scioto Darby City School System in Hilliard but was soon restless. "Teaching high school, you spend a lot of your time trying to get ideas across rather than plowing new ground," he says. "You top out fairly quickly intellectually."

Szente returned to Ohio State, where he received an MBA in 1978. A year later he was helping to guarantee the retirements of his former colleagues, as an equity research analyst covering banks,

utilities and insurance companies for the State Teachers Retirement System of Ohio. He stayed put for 16 years, rising to director of the fund's equity research department in 1982. By 1986 he was the assistant director of investments, with oversight of more than $30 billion, all managed internally.

In Ohio Szente gained a useful schooling in the basics of portfolio management and broadened his expertise beyond public equities, to real estate and fixed income. "I got a late start in this business, but I made up a lot of ground there," he says. In 1995 Szente moved to Maryland to run a $1.9 billion equity portfolio for the endowment of the Howard Hughes Medical Institute in Chevy Chase. Three years later he became director of research at McGlinn Capital Management in Wyomissing, Pennsylvania, which at the time had about $4 billion under management.

He had no interest in returning to the lumbering world of public fund investing until early last year when he learned, thanks to a Financial Times article, that CalPERS was seeking a new CIO. Szente decided to apply because, well, CalPERS is CalPERS. "This organization has long been regarded as a leader, and it's the only job at a big institution that I would have even considered taking," he says.

"What Dan brings to the table is just an excellent sense of how an equity portfolio should be structured," says CalPERS trustee Michael Flaherman. "That was absolutely crucial to us in our search process."

Szente certainly wasn't stepping into a backwater. Sheryl Pressler, CalPERS's CIO since 1994, had been pushing for rapid changes at the fund. The former director of retirement funds management for McDonnell Douglas Corp., Pressler brought a take-no-prisoners portfolio management style to the plan, which at the time had $80 billion and was 96.6 percent funded. CalPERS's average annual return of 12.09 percent during the 1988-'93 period placed it in the third quartile of all public funds. Pressler thought she could do better.

She got the board to boost the plan's overall equity target from 49 percent to 63 percent, slashing fixed income from 43 percent to 29 percent and leaving the rest of the portfolio more or less intact. Pressler stuck to CalPERS's passive approach - since its first equity allocation in 1967, more than 75 percent of its stock portfolio has been indexed - but she thought that the plan needed to be more active in private equity and real estate investments.

In 1996 she recruited Barry Gonder, director of alternative investments at insurer Connecticut Mutual, to oversee the fund's private equity portfolio. At that time, CalPERS's private equity investments were less than 3 percent of assets; they now stand at 4.5 percent - some $8 billion - and the target has been raised to 6 percent. The change has proved rewarding: In 2000 alternative assets returned 25 percent, compared with 15 percent for its benchmark.

Not long after Pressler arrived, her deputy, Robert Boldt, began to pitch for CalPERS to invest in hedge funds. Institutional investors then represented just 5 percent of hedge fund assets, according to Cerulli Associates, far below today's 25 percent, and it seemed an unlikely foray for CalPERS. But Pressler was sympathetic to the idea.

Boldt, like many investors, saw in hedge funds an asset class that would let CalPERS diversify risk and get higher returns. Hedge fund supporters have long argued that the investments are uncorrelated with public equities. (Whether this is true has lately become the source of considerable debate; see Money Management, page 31.) Boldt also believed that investing in hedge funds would give CalPERS access to the finest portfolio managers in the world.

"The best and the brightest are still migrating to hedge funds," says Boldt, who left CalPERS last year to join Pivotal Asset Management, a San Francisco hedge fund with which CalPERS has invested $300 million. "The very good money managers don't want to work for behemoths."

Says CalPERS trustee and economist Flaherman, head of the investment committee and a six-year veteran of the board, "Bob recognized that the industry had evolved and that there were a substantial number of opportunities that were appropriate for us and that we needed to have a bucket to put them in."

In August 1999 the CalPERS board approved the move into hedge funds. Though it did not establish a specific allocation target, it capped the fund's exposure at 25 percent of its externally managed money - about 7 percent of its total assets.

The decision assumed enormous importance for other pension plans and hedge funds, especially after an enterprising Bloomberg reporter did some elementary arithmetic and calculated that CalPERS could conceivably lay out upwards of $11 billion on hedge fund investments. "I told the reporter: 'I'm not going to argue with your math, but it is misleading. It's a theoretical number,'" says Boldt. CalPERS had no intention of investing anything like that, but the number took on a life of its own.

Immediately, CalPERS's move was touted as a watershed event that would entice other public funds

into the murky world of hedge funds, little more than a year after the high-profile collapse of Long-Term Capital Management. Boldt was inundated with calls and e-mails from hedge fund managers and consultants.

"A lot of people expected CalPERS to do what it always does, which is barge ahead and hire a manager to run $5 billion. When that didn't happen, people said we were going disappointingly slowly," says Boldt. "My recommendation was that we invest in hedge funds opportunistically. I didn't want our first three or four choices to be flops."

That October Pressler and Boldt recruited Mark Anson, a portfolio manager at OppenheimerFunds, to run the hedge fund program and help oversee the fund's domestic equities investments. On the advice of Wilshire Associates, CalPERS selected Pivotal as its first hedge fund manager. The pension fund was drawn to Pivotal's expertise in technology and its solid one-year track record. In addition, CalPERS's staffers knew the executives who ran Pivotal. The plan committed $300 million to the Pivotal Partners Fund, which focuses on computer-related tech companies. A few months later the fund followed up with a $125 million investment in another hedge fund, the Abacus Fund, a limited partnership managed by Boston-based ABRY Partners, which specializes in media investments. (CalPERS says it is still too early to provide performance returns on the fund's investments with Pivotal or Abacus.)

The momentum might have continued, but in January 2000 Pressler announced that she was leaving CalPERS to become the CEO of Lend Lease Real Estate Investments, an asset management company. (Pressler, who left Lend Lease this March for personal reasons, declined a request for an interview.) "Sheryl didn't want to move ahead aggressively once she knew she was leaving," Boldt says.

Boldt took himself out of the running to succeed Pressler as CIO, and in May he left CalPERS altogether. He says that he wanted to return to the private sector, and this past January he took a job at Pivotal, where he now works as a managing director.

A pension plan executive helps to hire a money manager and shortly thereafter goes to work for that same money manager: That's the kind of career segue that seems a little too cozy to some observers. Boldt, for his part, says that his work at Pivotal does not involve the fund in which CalPERS invested. A spokesman for the California plan says it isn't uncommon for former employees to take jobs in the private sector with money managers or advisers with which CalPERS has relationships.

In any event, Boldt's departure had one immediate effect: CalPERS's hedge fund program stalled.

When Szente arrived last May, he acted quickly to shore up his staff. He tapped Curtis Ishii to run fixed income and Richard Hayes to help Gonder run the alternative assets group, and he promoted Anson to senior investment officer of global equities. Anson advocated a revival of the hedge fund program, and Szente gave him the go-ahead.

After the investing hiatus, Szente and Anson wanted to demonstrate their serious commitment to hedge funds. Last October Anson asked the CalPERS investment committee to approve a defined target of $1 billion. Anson says he wanted to send a signal to the market and picked $1 billion "because it was of sufficient size to have an impact on the hedge fund industry and on my equity portfolio, but not so large as to overwhelm the hedge fund industry or exceed 1 percent of CalPERS's assets."

Fielding queries from a host of fund managers he knew little about, Anson hired an outside firm to act as adviser and gatekeeper. He hopes to select a consultant within the next few months. "I'm sure there are a lot of hedge fund managers out there who just aren't on our radar screen, or maybe they don't want to contact me because they're afraid to talk to pension funds," says Anson.

With CalPERS planning to divide its $1 billion among five or ten managers, Anson feels confident that no one firm will be overwhelmed. "The average manager will absorb $100 million or $200 million. I don't think that would hurt most managers."

More contentious will be CalPERS's effort to negotiate terms of disclosure with managers. For now, CalPERS intends to encourage some transparency by requiring managers to file quarterly reports with InvestorForce, an online money manager database in which CalPERS took a 10 percent stake last fall. Of course, the plan will have to resolve with its hedge fund managers precisely how much sensitive detail will be included in those reports.

It remains to be seen which hedge fund managers will play along. "We will not alter the entire disclosure process in any way that could hurt our fund," says one manager.

"Quite frankly, hedge fund guys went into the business of hedge funds because they didn't want to tell anybody what they were doing," says Szente, who calls CalPERS's move into the funds an experiment. "I can't fault them for that. All we're offering is an opportunity to those who would like to do business with

us."

Anson has another objective. He serves as co-chairman of an industry group of pension and hedge fund executives that is working to create a standard of disclosure for the industry. "There's a trade-off between what I need to manage risk and what hedge fund managers are willing to disclose. I can understand the nature of their secrecy, but they also need to understand the nature of my need to manage risk."

Szente says CalPERS is looking for "conservative" hedge funds, although as he and his staff well know, that concept is not easily defined. He makes clear that CalPERS has no interest in quantitative "black box" firms that use sophisticated computer algorithms designed to exploit market inefficiencies.

"The black-box firms are either very reluctant to let us look at their algorithms or they just might be too sophisticated to be properly understood," says Anson. "Still, I'm not going to foreclose investing in them sometime down the road."

Anson expects that most of the plan's hedge fund assets will be directed to long-short or market-neutral equity funds. "Their competitive advantage is that they just know more. They can go long on companies they think are good, and they can go short on companies they think are bad," says Anson, who is also leery of too much leverage. "We'll accept a leverage ratio of no more than 2-to-1."

Other pension funds had INVESTED IN HEDGE funds before CalPERS came calling, but the California plan staked out new territory when it bought pieces of Carlyle and Texas Pacific.

The deals followed a pattern established over the past two years in which CalPERS picked up small pieces of money managers, hoping to gain early access to new investment ideas as well as equity interests in promising new ventures. The fund has taken a $422 million minority stake in Boston-based Audax Group and a $100 million minority interest in New Mountain Capital, the New York-based firm run by ex-Forstmann Little & Co. partner Steven Klinsky. CalPERS has also shelled out $100 million for a 10 percent stake in technology merchant bank Thomas Weisel Partners and holds ownership positions in Cambridge, Massachusetts-based Arrowstreet Capital.

Late in 1999 alternative asset chief Gonder advocated applying a similar approach to private equity investing. The idea: to better exploit CalPERS's knowledge of the private equity business. "We began asking ourselves, 'What's the industry we know best?' It's private equity," says Gonder. "We asked ourselves, Who are the best private equity firms out there? Who are the people we want to be in business with for the next five, ten, 30 years?"

As with hedge funds, Flaherman was the board member championing CalPERS's new strategy. "When I first came on the board in 1995, it was really clear that we were not maximizing the value of the relationship we had with many of our financial partners," he says.

In January 2000 Gonder met with David Rubenstein, a co-founder of Carlyle, with which CalPERS had first invested in 1996. (The other two founders are Daniel D'Aniello and William Conway Jr.) Gonder expressed CalPERS's ownership interest, but Carlyle executives were reluctant to dilute the stakes of the firm's partners. The chance came last June, when Washington, D.C.-based Carlyle, which boasts $5 billion under management and ranks as one of the country's largest private equity firms, bought out a 10 percent stake held by the Mellon family.

After several months of negotiations, the parties struck a $175 million deal that gave CalPERS a 5 percent stake in Carlyle's current portfolio - some 160 deals worldwide - as well as 5 percent of its deals going forward. CalPERS also agreed to commit $250 million to various new Carlyle private equity funds and has the option to possibly buy an additional 5 percent stake in Carlyle within the next two years.

For Carlyle, which manages multiple funds, CalPERS provided a welcome infusion of capital. Investors expect Carlyle to invest its own capital in the deals it puts together, and at the time, Carlyle was finding it increasingly difficult to come up with the requisite cash.

With CalPERS on board, Carlyle is hoping to attract a new class of potential partners. "It brings an array of contacts, and it probably sees more opportunities than anybody else," says Rubenstein.

A day before the Carlyle announcement, CalPERS unveiled a similar agreement with San Francisco-based Texas Pacific. The deal gave CalPERS a $60 million minority ownership stake in TPG's new venture capital subsidiary, TPG Ventures. CalPERS committed $325 million to invest via the new fund and an additional $100 million to other Texas Pacific investment partnerships.

Although other large institutional investors have bought into private equity firms - Putnam Investments bought a stake in Thomas H. Lee Partners in 1999, and American International Group acquired a 7 percent stake in Blackstone Group in 1998 - CalPERS is the first public fund to do so. Says Szente: "We

want to create relationships with these people because they are first-rate funds. It's not something you're going to see lots more of, because there are only so many firms of this quality out there. I've gotten calls to buy all kinds of investment firms. That's not what we're doing."

If hedge funds and private equity offer the lure of the new, junk bonds are a familiar - and troubled - stomping ground. The plan has been investing in junk bonds for about the past 15 years, with mostly mediocre returns. CalPERS didn't begin to break out the returns of its high-yield portfolio until last year, but staffers concede that the category has been one of its weaker performers. Last year was an exception: The fund's high-yield portfolio returned 6.44 percent, versus -5.68 percent for the Salomon Brothers high-yield index.

In March the fund's investment staff asked the board to double the target allocation to junk bonds, to 10 percent of the fixed-income portfolio - $3.7 billion. At the end of the first quarter, CalPERS actually had just 1.5 percent of its bond portfolio in high-yield securities.

CalPERS moved into the high-yield market back in 1987 and beat its benchmark for the next two years. But in 1990, the year of the Drexel Burnham Lambert Group bankruptcy and the implosion of the junk market, the portfolio began to unravel. The board quickly decided to wash its hands of the whole sector, directing staff to liquidate all junk bond holdings. By March 1993 the job was done.

Many at CalPERS regard the sale as a huge mistake. "When we divested our high-yield bond portfolio, we lost money," Robert Carlson, a member of CalPERS's investment committee, recalled at a March committee meeting. "It was a bum decision."

In 1996 CalPERS returned to the asset class, albeit accidentally, when the credit ratings for some of its corporate bonds fell to junk status. That same year the staff asked the board to approve the current 5 percent target.

With junk bonds now trading at 750 basis points over Treasuries - spreads not seen since late 1998, when the ruble collapsed and Long-Term Capital exploded - Szente, for one, thinks the values are too good to last. "This is an enormous opportunity that we should not be missing. We will blow through the 5 percent like a hot knife through butter, because the opportunities are there."

CalPERS certainly is not the only pension fund to rediscover the value in high yield. Szente, like his counterparts, acknowledges the risk of serious junk bond defaults should an economic downturn get ugly. And, he adds, "CalPERS is going to live and die by the equity markets by virtue of our size. When push comes to shove, the public markets are where we can put $100 billion."

It's no wonder Szente returns again to the driving philosophy behind all of CalPERS's newfound assertiveness: The plan must seize opportunities for equitylike returns wherever it can find them. That's especially true now that the Dow Jones industrial average and Nasdaq composite index are both reeling and equity markets haven't been offering anyone equitylike returns.

CalPERS's seal of approval

Even as it dives deeper into the hedge fund universe and buys stakes in private equity firms, the California Public Employees' Retirement System is also overhauling the way in which it invests in emerging markets.

This is thanks to Philip Angelides, a hard-charging Democrat who joined CalPERS's board when he was elected state treasurer in 1998. Angelides, a 47-year-old former real estate developer, waged an 18-month battle to persuade CalPERS to shift its poorly performing $1.8 billion emerging markets allocation from passive to active management. Notably, too, he pushed the fund to impose human rights and free-speech standards on its investments in developing nations. Wilshire Associates, CalPERS's consultant, is currently developing a set of "permissible country" guidelines that take into account social and political issues to judge whether a country is suitable for investment.

"CalPERS already had a set of screens in place - things like market liquidity, transparency within the financial markets," Angelides says. "We added three more: political stability, freedom of the press and a basic regard for human rights in terms of labor practices. Governments aren't putting hundreds of thousands of people in jail because things are going well. We need to see that these countries are making progress toward developed nation status."

Critics say Angelides, a Greek-American, targeted the emerging markets investments as a way of creating political capital among the Greek community in California. Angelides criticized a report presented by Wilshire in April 1999 that classified long-time adversaries Greece and Turkey as two

countries in which the fund should have limited exposure. Angelides's criticisms set off a dispute with fellow trustee Charles Valdes. At an October 1999 trustee meeting, Valdes, who was then chairman of the investment committee, made his feelings known. "What we have here," he said, "is a Greek treasurer who doesn't like Turkey; who doesn't like Turks; who is trying to amend our policy . . . according to these ethnic hatreds." His comments caused an uproar, and by February 2000 he was forced to give up his chairmanship of the investment committee, though he remains a member of the board.

Angelides insists his argument is largely based on the bottom line. "The returns of emerging markets then and emerging markets today have been mixed at best, strikingly poor at worst," he says. "I said we need to critically analyze why we are in these markets and how we can be in them in a way to foster better returns." The fund's emerging markets investments declined 13.4 percent in 1998, versus an 18.5 percent gain for CalPERS's overall portfolio. However, the fund has not broken out its emerging market returns for the last two years.

Chief investment officer Daniel Szente is a reluctant supporter of the new investment guidelines. "I would do it differently than what the board is doing," he says, "but what they're doing is not unreasonable, and it is their choice." Szente says he would prefer a system that screens out specific companies, rather than entire countries. "I'm working with them to put together the best emerging market program."

Under the guidelines, which are still being developed, CalPERS would add Brazil, Egypt, Indonesia, Malaysia, Peru and Turkey to its current list of 15 countries in which it cannot invest. (China, the biggest emerging market of all, is already on that list.) At the moment, CalPERS invests in most of those countries. (In November CalPERS decided Greece was an appropriate country in which to invest.)

State Street Global Advisors currently oversees the fund's emerging markets investments. But CalPERS is conducting a search for a new active manager and has narrowed its list of finalists to 15 candidates. It will make a final selection in November. Says Angelides, "If the approach we've adopted doesn't yield better results, I'll be the first to say let's reevaluate."

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